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Weekly Commentary, Selected Financial Data, and Business Indicators

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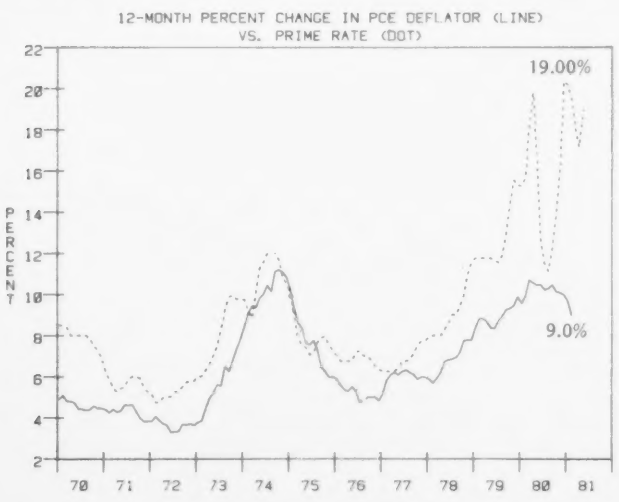
The Soaring "Real" Cost Of Borrowing . . .

One of the more noteworthy features of current financial market developments is the ever-widening divergence between rates of inflation and interest. Over the past year, the rate of inflation as measured by every price index—whether the personal consumption expenditure deflator, consumer price index or producer price index—has decelerated significantly. The consumer price index, for example, increased at a 7.2 per cent seasonally adjusted annual rate in March, down from the 12 per cent annual rate of rise posted in February, and a more than 15 per cent annual rate of rise registered in March, 1980. What is more, much of the increase in the price indexes that is occurring still reflects the impact of the sharp escalation of energy prices that resulted from the OPEC-mandated oil price hikes in December and the decision to deregulate immediately domestic oil prices in late January. Once the diminishing effects of these actions pass completely through the price indexes even lower inflation rates can be expected.

But the cooling of inflation has not been paralleled by a similar moderation of interest rates. In fact, quite the opposite has occurred. Both short- and long-term interest rates have ratcheted upward sharply in recent weeks, reflecting the impact of a variety of negative economic and financial developments (Financial Digest—April 27, 1981). Short-term interest rates have increased by an average of three to four full percentage points since the end of March, while bond yields have also moved sharply higher—in this case, to new record highs. Top-quality corporate yields increased from 100 to 125 basis points during the period, and long-term governments, Federal agencies and municipal bond rates all moved substantially higher.



As a result, with interest rates soaring and inflation rates decelerating, "real" interest rates and, of course, the real cost of borrowing have surged upward. As indicated in the chart to the left, the prime rate (at 19.00 per cent) now stands ten full percentage points above the most recent 12-month change in the personal consumption expenditures deflator (nine per cent).

This differential is just about double the average magnitude that existed in 1980 (5.04 percentage points)—and almost five times greater than the average differential which existed during the 1970-1980 period (2.11 points).

Similarly, lofty real borrowing costs now prevail in the long-term bond markets. With composite, new issue double-A utility yields standing at or near 16.00 per cent, the differential between these rates and the rate of inflation has reached a sizable 700 basis points (see chart above)!

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This gap is almost two and one-half times the spread that existed in 1980 (2.92 percentage points) and almost three times the size of the average differential that prevailed during the 1970-1980 interval (2.46 points).

. . . Does Not Augur Well For Business . . .

Clearly, with high-quality utility debt now yielding 16 per cent, the financial markets must be anticipating a rate of inflation far above present levels. If the past is any guide, yields prevailing today would be warranted if the rate of inflation, or at least the expected rate of inflation, stood in excess of 13 per cent—not nine per cent. And even if allowance is made for inclusion of a larger-than-normal inflation rate premium in nominal bond yields due to the recent volatility of the inflation statistics, real interest rates of seven per cent in the bond markets still seem excessive. The rate of inflation as measured by the PCE deflator could increase by 50 per cent compared with its most recent 12-month change, and the real rate of interest would still be greater than the average differential that prevailed in the 1970-1980 period.

The sharp upturn in the real cost of borrowing must be treated with caution by business. For in the absence of ongoing high rates of inflation, it can only become more difficult for business to incorporate fully such substantial borrowing costs in their pricing structures. And with debt service payments

Selected Federal Reserve Data

(Averages of Daily Figures—Billions of Dollars)

	Week Ending 4/29/81	$ Change Since Week Ago	$ Change Since Year Ago
Reserve Bank Credit			
U.S. Gov'ts and Agencies Owned Outright & RPs	128.513	– 2.868	+ .127
Loans to Depository Inst.	2.278	+ 1.414	– .385
Float	3.087	+ .067	– .522
Total Reserve Bank Credit	144.474	– 1.230	+ 4.492
Treasury Deposits with Federal Reserve Banks	3.536	– .433	– .309
Currency Outside Banks	121.256	– 1.632	+ 9.237
Member Bank Reserves:			
Required	41.004	+ .265	– 4.030
Excess (Deficiency)	–.046	+ .369	– .206
Total Reserves Held	40.958	+ .634	– 4.236
Net Borrowed Reserves	2.149	+ 1.019	– .185
Gov'ts held for Foreign Acct. by F.R. Banks (End-of-Week)	101.725	+ 1.134	+27.680

Monetary Aggregates†		% Change Since Three Months Ago*	% Change Since Year Ago
M-1A	363.6	– 10.1‡	– 0.3‡
M-1B	428.6	+ 12.5‡	+ 11.3‡
M-2 (March '81)	1,716.5	+ 11.5	+ 10.3
L (January '81)	2,398.2	+ 14.0	+ 10.5

†Seasonally adjusted. * Seasonally adjusted annual rate. ‡Four-week moving average.

New York Money Market

Offering Rates 5/8/81	3 Months	6 Months	1 Year
‡U.S. Treasury Bills	16.45%	15.45%	14.35%
* Federal Agencies	17.19	16.89	16.16
* Project Notes—Taxfree (46% Taxable Equivalent)	12.41	14.07	13.06
Negotiable Time CDs Manufacturers Hanover	Rates By Arrangement		
* Secondary Market—Prime	17.88	17.50	

‡Finance Company Paper—Prime		‡* Bankers' Acceptances	
5- 14 days	18.00%	Jun.	18.40%
15- 29 days	18.00	Jul.	18.10
30- 59 days	17.50	Aug.	17.95
60- 89 days	16.75	Sep.	17.70
90-179 days	15.25	Oct.	17.25
180-209 days	15.25	Nov.	16.75

‡Industrial Paper—Prime			
30- 89 days	18.13%	†Federal Funds Effective Rate	18.07%
90-120 days	18.00		

‡Discount basis. * Subject to availability. † Estimated.

Selected Business Indicators

(All Dollar Figures in Billions)

	Latest Period or End of Period		Previous Period	Year Ago Period
Gross National Product (Current Dollars)*	1st Q'81	$ 2,827	$ 2,731	$ 2,572
Gross National Product (1972 Dollars)*	1st Q'81	$ 1,509	$ 1,486	$ 1,502
Percent Change, Annual Rate	1st Q'81	6.5%	3.8%	3.1%
Change in Consumer Prices (all urban consumers)*	Mar '81	7.2%	12.0%	15.6%
Change in Producer Prices*	Apr '81n	9.6%	15.6%	9.6%
Civilian Employment (Thousands of Persons)†	Apr '81n	98,976	98,412	97,225
Unemployment as % of Civilian Labor Force†	Apr '81n	7.3%	7.3%	6.9%
Personal Income*	Mar '81	$ 2,335	$ 2,317	$ 2,101
Leading Indicators Composite Index (1967=100)†	Mar '81	137.1	135.2	131.5
Industrial Production Index (1967=100)†	Mar '81	151.7	151.1	152.1
Net Change in Consumer Installment Credit†	Mar '81n	$ 3.11	$ 2.00	$ 0.65
U.S. Merchandise Trade Balance†	Mar '81	$ 0.48	–$ 2.16	–$ 2.68
Plant and Equipment Expenditures*	2nd Q'81	$317.29(a)	$310.59(a)	$294.36
Private Housing Starts (Thousands of Units)*	Mar '81	1,284	1,214	1,040
New Construction Expenditures*	Mar '81	$ 248.0	$ 254.0	$ 237.1
Total Business Inventories†	Feb '81	$ 470.0	$ 465.1	$ 435.2
Total Business Sales†	Feb '81	$ 345.2	$ 345.6	$ 310.2

*Seasonally adjusted annual rate. †Seasonally adjusted. n-Newly reported figure. a-Anticipated.

already absorbing a record proportion of nonfinancial business cash flows, rising real borrowing costs certainly do not augur well for the health of corporate balance sheets. One sign of weakness: The soaring number of business bankruptcies. Specifically, during the first four months of 1981, the number of business failures was almost 50 per cent higher than the level of failures recorded during the comparable period of 1980.

. . . And For Profits . . .

Despite a hefty 6.5 per cent advance in the "real" GNP in the first quarter compared with the preceding quarter, and a welcome deceleration in the rate of inflation, corporate profits were not all that healthy. In fact, preliminary estimates by this Bank indicate that pretax profits (adjusted for inventory gains) were about five per cent below their year-earlier record levels. However, this year-to-year comparison masks a wide variance in the performance of specific industries.

For example, the spectacular gains posted by the oil companies at the beginning of last year boosted overall pretax profits by $31 billion, at a seasonally adjusted annual rate. Since then, these gains have faded substantially and during the first quarter of 1981 were about 40 per cent lower than year-ago levels. Consequently, if oil industry earnings were excluded from overall profits, the five per cent year-over-year decline would turn to a very slight

Short Term Paper Outstanding

(Millions of Dollars)

	Latest Week	Change Since Week Ago	Change Since Year Ago
Negotiable Time CD's Weekly Reporting Banks			
Nationwide (4/22/81)	113,056	+ 1,398	+17,809
New York City (4/22/81)	28,301	+ 107	+ 6,611
Commercial Paper (4/22/81)	137,741	+ 2,612	+14,748

Bank Loans

(Millions of Dollars)

Commercial and Industrial Loans

Weekly Reporting Large Commercial Banks	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (4/22/81)	172,365	+ 1,275	+11,174
New York City (4/22/81)	50,642	+ 518	+ 3,612

Total Loans Gross Adjusted

	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (4/22/81)	427,481	– 508	+27,791
New York City (4/22/81)	100,583	– 1,042	+10,505

Financial Markets

	Friday 5/8/81	Change Since Week Ago	Change Since Year Ago
U.S. Governments, Closing Yields:			
90-Day Bills†	17.30%	+ 1.91	+ 8.07
180-Day Bills†	16.95	+ 1.74	+ 7.56
Longest Bills†	16.10	+ 1.14	+ 6.59
Recent Issues:			
14 1/2s 4/30/83 (When Issued)	15.66	NA	
13 3/8s 3/31/85	15.45	+ 1.06	
14 1/2s 5/15/91 (When Issued)	14.20	NA	
13 7/8s 5/15/11 (When Issued)	13.75	NA	
Municipals:			
Bond Buyer–20 Bond Index* (5/7/81)	10.90%	– .04	+ 3.79
Blue List Total ($ Million)	$ 721	– $ 89	+ $ 9
30-Day Visible Supply ($ Million)	$1,928	– $508	– $ 281
Total	$2,649	– $597	– $ 272
Corporates:			
Moody's Aa Composite (5/7/81)	15.13%	+ .33	+ 3.38
Money Mgr.–30-Day Supply ($ Million)	$6,528	– $ 82	+ $4,549
Stocks:			
Dow-Jones Averages:			
Industrials	976.40	– 19.19	+ 170.60
Transportation	418.40	– 7.46	+ 168.74
Utilities	105.56	+ .04	– 2.86
65 Stocks	377.71	– 5.53	+ 85.76
Standard and Poor's 500 Stocks	131.58	– 1.14	+ 26.86
N.Y.S.E. Composite Index	76.13	– .62	+ 16.34
N.Y.S.E. Avg. Daily Vol. for Week (000's)	44,254	– 7,632	+ 6,934

* 46% Taxable equivalent 20.19%.

† Bond equivalent.

International Rates

EURODOLLAR DEPOSIT RATES (bid)	Friday 5/8/81	Week Ago
Overnight	18.25%	18.00%
1 month	19.38	17.50
3 month	19.63	17.50
6 month	18.88	17.38
1 year	17.75	17.75
EURODOLLAR BONDS		
Average Yield		
Medium Term (5 to 7 yrs.)	14.40%	14.30%
Long Term (7 to 15 yrs.)	14.50	14.40

FOREIGN EXCHANGE SPOT RATES

New York Opening (5/8/81)	U.S. $ Equivalent	Currency Per U.S. $
Belgium	.02723	36.72
Canada	.8344	1.1985
Denmark	.1409	7.0950
France	.1869	5.3500
Germany	.4439	2.2530
Italy	.0008897	1124.00
Japan	.004595	217.65
Mexico	.04161	24.03
Netherlands	.3998	2.5010
Switzerland	.4874	2.0515
U.K.	2.1135	.4731

advance. Importantly, the petroleum and coal industry accounted for more than 12 per cent of total corporate profits in 1980—virtually double the 6.3 per cent share just two years before.

Benefiting from the partial decontrol of domestic crude oil prices as well as the sharp rise in world prices, oil companies' earnings rose rapidly during the first half of 1980. During the latter half of the year and continuing into 1981, the gains slowed significantly especially in the marketing and refining end. Despite the complete decontrol of domestic oil prices in January, declining demand in response to rising prices and the increasing bite of the "windfall" profits tax reduced profitability and, in some cases, resulted in outright losses.

At the other side of the profits spectrum are the nation's thrift institutions. They have been confronted with an ever-more volatile deposit base—as other market instruments such as money market funds have become more attractive. Those funds that the thrifts have been able to obtain have become more expensive, as depositors have shifted their accounts from the traditional passbook accounts into high-yielding six-month money market certificates and 2-1/2 year, small-saver certificates. The demand for mortgage loans remained sluggish primarily due to the weakness in the housing sector. The high costs of financing a home—reflecting high mortgage interest rates and lofty home purchase prices—have discouraged many potential buyers and thus dampened the demand for mortgages.

Despite the temporary rebate-induced jump in unit sales, domestic automobile manufacturers again reported dismal earnings. Two of the Big Three producers recorded significant losses. Production recovered slightly during February and March, but remained 11 per cent below the weak, year-earlier level. Furthermore, as a result of the ongoing slump in the industry, its suppliers continue to be adversely affected. The auto accessories industry has now experienced two years of weak profits growth with net income falling by 22 per cent compared with a year ago.

The nonferrous metals industry in general and copper producers in particular registered a sharp reversal in profit performance—from extremely favorable income comparisons a year ago to negative currently—hurt by sharply lower commodity prices and slackening demand. Copper prices skyrocketed in early 1980 due to increased speculation in non-precious metals and stepped-up demand in anticipation of the industry-wide strike against producers. However, since then, speculation subsided and the ongoing slump in the auto industry and renewed weakness in new housing construction—the two largest consumers of copper—reduced demand significantly and the price dropped by almost 45 per cent from last spring's peak.

. . . But Does Bolster The Dollar

One of the important effects of the recent rise in U.S. interest rates is the upsurge in the value of the dollar against other major currencies. The recent interest rate spiral has stimulated a tidal wave of speculative funds from abroad as investors rush to lock in higher rates of return in the United States. The demand for dollars has driven the U.S. currency to a ten-year high against the Franch franc, a 30-month high against the German mark and a record high against the Italian lira—1,130 lire to the dollar at the opening of the New York market on May 5.

Since the beginning of 1980, the exchange rate of the dollar has been remarkably responsive to changes in short-term interest rates in the U.S. and in the Eurodollar markets. Recently, as the rate of inflation in the U.S. has begun to slow and, consequently, as real interest rates have risen, the dollar has moved ahead with only minor interruptions. Even if short-term interest rates decline in the near future, the dollar is expected to remain strong. This strength stems not only from economic fundamentals, but from psychological factors as well. Expectations are that the Fed will continue its tight monetary policies keeping interest rates high. In addition, the rate of inflation should continue to decline. Improving trade statistics so far this year encourage the expectation of a current account surplus for 1981. At the same time, other major trading countries that are struggling with low real growth rates or outright recession are reluctant to raise their interest rates to compete for funds with the U.S. (and consequently to strengthen their currencies). Such psychological factors as political uncertainties in Eastern Europe and the Middle East as well as generally favorable foreign opinion of the Reagan economic program add less tangible but, nevertheless, important strength to the outlook for the dollar.

A very strong currency is, however, a mixed blessing. For the United States it means cheaper imports and higher profits on exports denominated in dollars. In the longer term it means that our exports are less price competitive. To other countries, a strong dollar means more expensive imports, particularly oil, and adds to inflationary pressures. These effects are especially damaging to the less developed non-oil exporting countries which pay for many of their essential imports in dollars (although their exports are usually denominated in dollars, too). In the longer term, the countries whose currencies have been effectively devalued by a rising dollar will find that their exports have become more price-competitive. It is this mechanism which eventually will help to establish a new equilibrium between currencies and, hopefully, a period of exchange rate stability. H